COMMONWEALTH OF VIRGINIA, ex rel.

STATE CORPORATION COMMISSION

v. **CASE NO. SEC980044**

PARAMOUNT COMMUNICATIONS & COMPANY, INC.,
PARAMOUNT PAYPHONE SOUTHERN LLC,
PARAMOUNT PAYPHONE EASTERN LLC,
PARAMOUNT PAYPHONE LLC,
PARAMOUNT PAYPHONE SELECT LLC IV,
EDWARD MCCABE,
CHARLES SCHOOLCRAFT,
JAMES O. BAXTER, JR.,
and
ROBERT HAWKINS,
Defendants.

REPORT OF HOWARD P. ANDERSON, JR., HEARING EXAMINER

March 26, 1999

HISTORY OF THE CASE

By Rule to Show Cause dated June 24, 1998, the Division of Securities and Retail Franchising (the "Division") alleges numerous violations of the Virginia Securities Act (hereinafter referred to as "the Act") by Paramount Communications & Company, Inc. ("Paramount"), Paramount Payphone Southern LLC, Paramount Eastern LLC, Paramount Payphone LLC, Paramount Payphone Select LLC IV (the "LLCs"), Edward McCabe, Charles Schoolcraft, James O. Baxter, Jr. and Robert Hawkins (collectively "Defendants," unless individual name is used) requiring them to show cause why they should not be penalized for violations of Sections 13.1.-502, 13.1-504 A, 13.1-504 B, 13.1-507 and 13.1-521 of the Code of Virginia. The Rule ordered the Defendants to file a responsive pleading to the Rule on or before July 17, 1998.

On July 17, 1998, James Baxter filed a Response stating that he attended a seminar around March of 1996 sponsored by Paramount Payphones. At the seminar Mr. Baxter states he was assured that the units of membership were not securities and that the LLCs required active participation on the part of all owners. Mr. Baxter contends that he personally told all potential owners that involvement in the LLCs would require active participation and that all owners signed a document to that effect. (Response at 1). Mr. Baxter further states in his Response that all owners received written disclosure that Mr. McCabe had been sanctioned by the Commodity Futures Trading Commission; however, Mr. Baxter claims he had no knowledge of sanctions by state regulatory agencies. Mr. Baxter also denies any wrongdoing. (Response at 2).

On July 20, 1998, Robert Hawkins filed a Response stating that he attended a meeting sponsored by Paramount Communications in Newport News, Virginia, and was assured that the memberships were not securities because they were not passive investments. In fact, Mr. Hawkins states that he was told that the State of Virginia had reviewed the program and had deemed it not to be a security. (Response at 1). Mr. Hawkins further states that he discontinued operation with Paramount after he began to question their business practices in November of 1996. (Response at 2).

No responses were filed by Paramount, the LLCs, Edward McCabe, or Charles Schoolcraft.

The Defendants were ordered to appear before the Commission on July 28, 1998, and show cause why: (1) they should not be penalized pursuant to Section 13.1-521 of the Act, (2) be permanently enjoined from committing such violations of law in the future, and (3) be required pursuant to Section 13.1-518 of the Act to pay the actual costs of the investigation in this case. In his Response of July 17, 1998, Mr. Baxter stated he had not had sufficient time to secure legal counsel in this matter. By Hearing Examiner's Ruling dated July 23, 1998, this matter was continued generally pending further Ruling. The hearing was convened on October 15, 1998, pursuant to Ruling dated August 12, 1998. Defendants Baxter and Schoolcraft appeared pro se. Defendants Hawkins and McCabe did not appear. Jonathan B. Orne, Esquire, appeared as counsel for the Division. Proof of notice was marked as Exhibit A and made a part of the record. After the Division presented its case, Defendant Baxter requested and was granted a continuance to subpoena witnesses. The hearing resumed and was concluded on January 26, 1999. A transcript of the proceedings is filed with this Report.

SUMMARY OF THE RECORD

The Rule to Show Cause alleges that:

1. Paramount and the LLCs, at all times relevant hereto, employed McCabe, Schoolcraft, Baxter, and Hawkins to offer and sell, in Virginia and elsewhere, interests in public payphone operating ventures in the form of units of membership in the LLCs;

2. During 1996, McCabe, Schoolcraft, Baxter and Hawkins, acting as agents of Paramount and the LLCs, offered and sold interests in public payphone operating ventures in the form of units of membership in the LLCs in Virginia;

3. At the time he offered and sold the interests, Schoolcraft was subject to a final order of this Commission prohibiting him from offering or selling unregistered securities;

4. No Defendant, except Baxter, was registered under the Act in any capacity at the time of the transactions;

5. The securities offered and sold in Virginia by the Defendants were not registered under the Act;
6. The Defendants obtained funds from the investors by failing to disclose certain material facts, including the following:

    a. Failing to disclose that McCabe had been sanctioned by the Commodity Futures Trading Commission;

    b. Failing to disclose that Mr. Schoolcraft had been sanctioned by this Commission for the sale of unregistered securities; and

    c. Failing to disclose that McCabe, Paramount, and the LLCs had been sanctioned by the securities regulatory agencies of the States of Missouri, Arizona, Oregon, and Washington for offering and selling the securities in those states; and

7. At the time he offered and sold the securities, Baxter was registered under the Virginia Securities Act as an agent of a registered securities broker-dealer named US LIFE Equity Sales Corp.

Mr. Orne stated that the Division is proceeding in this case on the investment contract theory as set forth in the case of *Securities and Exchange Commission v. W.J. Howey Co. et al.* ("*Howey*") 328 U.S. 293, 66 S. Ct. 1100 (1946). Therein, the Court found that four elements must be present in order to establish a particular arrangement as an investment contract, and therefore a security. The arrangement must include: (1) an investment of money; (2) a common enterprise; (3) the expectation of profit, and (4) profits to be derived principally from the efforts of persons other than the investor. *Howey* at 298. "[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. . . ." (Id. at 298, 299). The Court went further to explain that, "[T]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. (Id. at 301). Section 2(1) of the Securities Act of 1933 (15 U.S.C.A. Section 77b(1)) defines the term "security" to include the commonly known documents traded for speculation or investment. This definition also includes investment contracts. If determined to be a security, the investment contract must be registered with the appropriate authority, in this case the Division.[1]

Three witnesses who purchased units of ownership in the LLCs testified to the facts surrounding their purchase of the membership units in various Paramount Payphone LLCs. John Dunn of Gloucester testified that, in March of 1996, Bob Hawkins contacted him about investing in a pay telephone venture. Mr. Dunn purchased two units of Paramount Payphone Southern LLC for $5,000 each or a total of $10,000. Based on a brochure presented by Mr. Hawkins, Mr. Dunn expected to double his money in five to six years. (Tr. 16). Mr. Dunn's check for $10,000 is dated March 28, 1996, and made payable to Paramount Communications & Co. Inc. (Ex. No. JWD-1, at

[1]Section 13.1-507 of the Code of Virginia provides that it is unlawful for any person to offer or sell any security unless the security is registered.

6). Mr. Dunn testified that he was not informed of sanctions against Ed McCabe and the companies with which he was affiliated. Had he been so informed, Mr. Dunn does not think he would have invested in Paramount. (Tr. 21). Mr. Dunn did not expect to be involved in the management of the venture; he expected only to vote on matters sent to him. (Tr. 20). Mr. Dunn received a check in the amount of $400 in April of 1997, representing a return on his investment.

Otis Lee of Charlottesville invested $25,000 in Paramount Payphone Eastern LLC. (Ex. No. OLL-7). Dr. Lee's check for $25,000 is dated May 13, 1996, made payable to and cashed by Charles Schoolcraft. (Ex. No. OLL-6). Although Mr. Schoolcraft related that Ed McCabe was president of the Company, he did not inform Dr. Lee that Mr. McCabe had been sanctioned by the Commodity Futures Trading Commission and by securities regulators in the States of Missouri and Arizona. Dr. Lee testified that, had he been told of these facts, he would not have invested in the venture. (Tr. 40). Dr. Lee stated that he had invested with Mr. Schoolcraft previously (Tr. 44), and that he had implicit confidence in Mr. Schoolcraft's ability to look out for him as an investor. (Tr. 43). Mr. Schoolcraft did not advise Dr. Lee that he had been sanctioned by this Commission for selling unregistered securities and acting as an unregistered agent in the sale of securities. (Ex. No. WRW-13). Dr. Lee also testified that he expected this to be a passive investment (Tr. 38, 39) and, that if he had been advised of Mr. Schoolcraft's sanctions, he would not have invested in this venture. (Tr. 40). Dr. Lee stated that he received $500 on his investment.

When Dr. Lee became concerned about his investment and made inquires, he discovered that Mr. McCabe was no longer associated with the venture and that the headquarters had moved to some other location. Dr. Lee then asked if he could sell his investments in the LLCs and was told that was not possible. Upon contacting Mr. Schoolcraft with this information, Mr. Schoolcraft advised that he was no longer associated with the venture. (Tr. 45).

Gloria Logan of Newport News testified that she invested a total of $15,000 on two separate occasions through Mr. Baxter. Mrs. Logan's check dated March 26, 1996, in the amount of $10,000, is made payable to Paramount Communications & Co. Inc. (Ex. No. GEL-10, at 1). Counsel also presented a membership certificate for one unit of Paramount Payphone Select LLC IV in the name of her husband, Alfred M. Logan. (Ex. No. GEL-9, at 2). Mrs. Logan did not recall whether Mr. Baxter mentioned the name of Ed McCabe or that Mr. McCabe had been sanctioned for previous securities transactions. Had she been so advised, she stated she would not have invested in the ventures. (Tr. 51). Mrs. Logan testified she did not expect to be involved in the management of the ventures; she expected this to be like other passive investments she had made. (Tr. 50, 52). Mrs. Logan stated that she received $400 on the first investment and has received nothing on the second investment, which was her husband's IRA account.[2] On cross-examination by Mr. Baxter, Mrs. Logan reiterated that, as she told him, she doesn't know much about investments, so she trusted him. (Tr. 55). Mrs. Logan testified that it was not until she received a later package that she realized that she was expected to participate actively in the venture. Upon informing Mr. Baxter that she did not have the time or money to go to Florida for board meetings, Mr. Baxter offered to go as her representative. (Tr. 57).

Despite the best efforts of the Defendants to portray their product as something other than a security, the evidence shows that the units of membership purchased by Mr. Dunn, Dr. Lee, and

[2]Mrs. Logan's husband works overseas. (Tr. 52).

Mrs. Logan are securities. The test set forth by the Court in *Howey* has been met. (*Howey* at 301). The investors expected to profit in this common enterprise solely from the efforts of others. Although each investor initialed a series of acknowledgments, which included a statement that his participation would be active, this was not pointed out to any of the investors at the time they purchased the units of membership. Each investor was led to believe that this was a passive investment that would afford them a profit. Not one of the investors realized, at the time of the transaction, that they were expected to actively participate in the venture.

There are other similarities in the Defendants' approach with each investor. The Defendants did not disclose previous sanctions by state and federal authorities imposed either on them, Ed McCabe, or the LLCs. In each instance, if this had been done, the investments would not have been made. As evidenced by the document initialed and signed by Mr. Dunn (Exh. No. JWD-1), it is obvious that these transactions were designed to avoid the protections afforded investors by state and federal securities laws. In fact, as argued by Mr. Baxter (Tr. 8), the elements that are required to constitute an investment contract (and therefore a security), were explained in promotional meetings. If successful, the scheme would accomplish two objectives. First, the Defendants would take money from the investors, and second, the securities laws would be circumvented. As discovered by Mr. Dunn upon further investigation, the payphones appeared to be junk, with disconnected wires and unstable mountings. (Tr. 22).

William Ward, a senior investigator with the Division, conducted an investigation of the allegations contained in the Rule to Show Cause. Posing as a potential investor, Mr. Ward contacted Mr. Schoolcraft and subsequently received a promotional video. (Ex. No. WRW-25). This video refers to the company as "Paramount" and depicts well maintained pay telephone equipment placed in profitable locations. Of course, the emphasis is on the profitability of the venture.

Mr. Ward offered documentation of sanctions imposed on Ed McCabe by the Commodity Futures Trading Commission (Ex. No. WRW-14), and evidence of sanctions imposed by the States of Missouri (Ex. No. WRW-15), Arizona (Ex. No. WRW-16), Oregon (Ex. No. WWR-17), and Washington (Ex. No. WRW-18) against Ed McCabe and Paramount Payphone Inc. Articles of Incorporation from the State of Nevada for Paramount Communications, Inc. show Ed McCabe as the president and sole incorporator. (Ex. No.WRW-19).

The four LLCs (Paramount Payphone LLC, Paramount Payphone Eastern LLC, Paramount Payphone Southern LLC, and Paramount Payphone Select LLC IV) were all formed in Nevada, and with the exception of Paramount Payphone LLC, all had letters signed by Ed McCabe, as president of Paramount Payphone Inc., authorizing the use of the "Paramount" name. The principal place of business of all four LLCs is 1350 East Flamingo Road, Suite 5, Las Vegas, Nevada.[3] Paramount Communications & Company, Inc. is the organizer of each LLC.[4] Ed McCabe, as president of Paramount Communications & Company, Inc., signed a letter welcoming Mr. Logan to the

[3]Ex. Nos. WRW-20, 21, 22, 23, Article Two.

[4]Ex. No. WRW-20, at 3; Ex. No. WRW-21, at 3; Ex. No. WRW-22, at 4; Ex. No. WRW-23, at 5, Article 4 in each case.

Paramount family and to the Paramount Payphone Select LLC IV. (Ex. No. GEL-9). Dr. Lee also received an identical welcoming letter from Ed McCabe, who signed as president of Paramount Payphone Eastern LLC. (Ex. No. OLL-7, at 2). Finally, as noted in the operating agreement of Paramount Payphone Southern LLC (Ex. No. WRW-24, at p. 27), all checks were to be made payable to Paramount Communications & Co., Inc. (Tr. 76). Once the capitalization of the LLC was complete, the management would be turned over to the members who had purchased units in the LLC. (Ex. No. WRW-24; Tr. 72).

Charges

The Division has alleged in paragraph (5) of the Rule to Show Cause that Paramount and the LLCs, at all times relevant hereto employed McCabe, Schoolcraft, Baxter, and Hawkins to offer and sell, in Virginia and elsewhere, interests in public payphone operating ventures in the form of units of membership in the LLCs.

Paragraph (6) of the Rule to Show Cause alleges that during 1996, McCabe, Schoolcraft, Baxter, and Hawkins, acting as agents of Paramount and the LLCs, offered and sold the securities in Virginia in several transactions with Virginia residents.

Paragraph (12) of the Rule to Show Cause alleges that the securities offered and sold in Virginia by the Defendants were not registered under the Act. The Division recommends that the LLCs be charged with registration violations under Section 13.1-507 of the Code of Virginia. (Tr. 70, 80).

Section 13.1-507 of the Code of Virginia provides: "It shall be unlawful for any person to offer or sell any security unless the security is registered under this chapter. . . ." However, upon careful examination of the evidence and the record in this proceeding I am unable to find that the Division has proven that any of the securities were unregistered. The Division has brought the Rule to Show Cause, therefore it has the burden of proof on all charges contained therein. Accordingly, all charges pertaining to registration of the securities must be dismissed for lack of evidence.

Based on the facts presented, there is evidence that Defendant McCabe violated Section 13.1-502 of the Code of Virginia which provides:

> It shall be unlawful for any person in the offer or sale of any securities, directly or indirectly,
>
> (1) To employ any device, scheme or artifice to defraud, or
>
> (2) To obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) To engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser.

It is evident the transactions described herein constituted a fraud upon the investors. The promotional tape shows McCabe describing the supposedly lucrative operation of the pay telephone ventures. The truth, as discovered by Mr. Dunn and Dr. Lee, was that these pay telephones were "junk" and investors were unable to recover their money. Furthermore, once the securities were sold by agents, McCabe disassociated himself from the venture and the investors were left "in charge of operations." Letters of welcome signed by McCabe as president of Paramount Communications & Co, Inc. and sent to Dr. Lee (Ex. No. OLL-7) and Alfred Logan, husband of Gloria Logan (Ex. No. GEL-9) are further evidence of McCabe's involvement. Finally, the check from Gloria Logan in the amount of $10,000 was made payable to Paramount Communications and Co., Inc.

According to paragraph (6) of the Rule to Show Cause, McCabe is alleged to have sold securities in Virginia. There is no evidence that McCabe sold securities in Virginia. Paragraph (5) of the Rule to Show Cause alleges that Paramount and the LLCs employed McCabe to offer and sell interests in public payphone operating ventures. There is no evidence that McCabe was employed by or an agent of Paramount and the LLCs as alleged in the Rule to Show Cause. While there is evidence that McCabe engaged in a scheme that would operate as a fraud or deceit, that charge is not alleged in the Rule to Show Cause. Because the evidence pertaining to McCabe and Paramount Communications & Co., Inc. does not fit the allegations contained in the Rule to Show Cause, they cannot be found to have committed any violations under the Act.

The Division has alleged in paragraph (8) of the Rule to Show Cause that the Defendants obtained funds from the investors by failing to disclose certain material facts:

(a) That McCabe had been sanctioned by the Commodity Futures Trading Commission;

(b) That Schoolcraft failed to disclose that he had been sanctioned by this Commission for the sale of unregistered securities; and

(c) That McCabe, Paramount, and the LLCs had been sanctioned by the securities regulatory agencies of the states of Missouri, Arizona, Oregon, and Washington for offering and selling the securities in those states.

Based on the evidence presented, I find that Defendants Hawkins, Schoolcraft and Baxter violated Sections 13.1-502(2) and (3) of the Code of Virginia. The Defendants failed to reveal the sanctions imposed on McCabe and the LLCs. As noted, the Defendants have been very skillful in their attempts to circumvent the securities laws by framing this venture as an investment requiring active participation by the investor. As noted, not one of the investors was made aware that his active participation in these ventures was required. In addition, the Defendants had the investor sign an acknowledgment that would insulate Paramount from any responsibility for their investment. (Ex. No. JWD-1, pages 30, 31). As explained by the three investors in this case, they were not advised or made aware of what they were signing. (Tr. 20, 38, 39, 50, 52, 56, 57).

Defendant Baxter sold Mrs. Logan units of membership on two separate occasions. Section 13.1-521 C of the Code of Virginia provides that "[E]ach sale of a security in violation of the

provisions of this chapter shall constitute a separate offense." Accordingly, I find that Mr. Baxter committed two violations of Sections 13.1-502(2) and (3).

By Order of this Commission dated November 6, 1995, Charles A. Schoolcraft was permanently enjoined from violating Sections 13.1-502, 13.1-504 or 13.1-507 of the Securities Act of Virginia. (Ex. No. WRW-13). I find that Mr. Schoolcraft further violated Section 13.1-504 A of the Code of Virginia by failing to disclose that he had been prohibited by this Commission from acting as a broker-dealer. (Tr. 40).

The Division has alleged in paragraph (9) of the Rule to Show Cause that, at the time he offered and sold the securities, Mr. Schoolcraft was subject to a final order of this Commission prohibiting him from offering or selling unregistered securities. The Commission Order is dated November 6, 1995. (Ex. No. WRW-13). Mr. Schoolcraft sold units of Paramount Payphone Eastern LLC to Dr. Lee in May of 1996.

The language of paragraph (9) of the Rule to Show Cause specifically states, "At the time he offered and sold the securities, Schoolcraft was subject to a final order of this Commission prohibiting him from offering or selling unregistered securities." Presumably, this allegation charges Mr. Schoolcraft with selling unregistered securities in violation of the Commission Order. However, the Division has failed to prove that the securities sold by Mr. Schoolcraft to Dr. Lee were not registered. Therefore this allegation must be dismissed for lack of evidence.

The Division has alleged in paragraph (10) of the Rule to Show Cause that, "[A]t the time he offered and sold the securities, Baxter was registered under the Virginia Securities Act as an agent of a registered securities broker-dealer named US LIFE Equity Sales Corp." Section 13.1-504 B of the Code of Virginia provides that "[N]o agent shall be employed by more than one broker-dealer or issuer." There is no evidence in the record that Mr. Baxter was employed by US LIFE Equity Sales Corp. as a broker-dealer, therefore this allegation must be dismissed.

The Division has alleged in paragraph (11) of the Rule to Show Cause that "[N]o Defendant, except Baxter, was registered under the Act in any capacity at the time of the aforesaid transactions.

Section 13.1-504 A of the Code of Virginia provides:

> It shall be unlawful for any person to transact business in this Commonwealth as a broker-dealer or an agent, . . . unless he is so registered under this chapter. . .

There is no evidence in the record pertaining to this alleged violation. There is no evidence that either Mr. Hawkins or Mr. Baxter was or was not registered under the Act. By Commission Order of Settlement dated August 4, 1998, Defendant Schoolcraft agreed not to apply for registration under the Virginia Securities Act as either a broker-dealer or as an agent for a period of ten (10) years from the date of this Order of Settlement. Although it can certainly be inferred from the Commission's Order that Schoolcraft is not registered, there is no direct evidence of this fact. Therefore this charge must be dismissed.

The Division has alleged in paragraph (12) of the Rule to Show Cause that '[T]he securities offered and sold in Virginia by the Defendants were not registered under the Act." Section 13.1-507 of the Code of Virginia states: "It shall be unlawful for any person to offer or sell any security unless the security is registered under this chapter . . ."

Again, after careful examination of the record of this proceeding, I find that there is no evidence that any of the securities were not registered. Therefore, allegations pertaining to the registration of the securities must be dismissed.

At the hearing, Investigator Ward recommended, on behalf of the Division, that extensive violations and penalties be imposed on the Defendants. (Tr. 79, 80). As a matter of due process, the alleged violations must be clearly set forth in the Rule to Show Cause. Accordingly, based on the allegations contained in the Rule to Show Cause and the evidence presented in this case, I find as follows:

1. That the units of membership in the LLCs sold to John Dunn, Otis Lee, and Gloria Logan are securities;

2. That Robert Hawkins sold a security to John Dunn by making omissions of material facts in violation of Section 13.1-502(2) of the Code of Virginia;

3. That James O. Baxter, Jr., on two occasions, sold a security to Gloria Logan by making material omissions of fact in violation of Section 13.1-502 of the Code of Virginia;

4. That Charles Schoolcraft sold a security to Otis Lee by making omissions of material fact in violation of Section 13.1-502(2) of the Code of Virginia;

5. That, pursuant to Section 13.1-518 of the Code of Virginia, Defendants Robert Hawkins, James O. Baxter Jr., and Charles Schoolcraft should be held jointly and severally liable for the costs of this investigation in the amount of $5,316 (Tr. 79);

6. That, pursuant to Section 13.1-521 of the Code of Virginia, Defendant Hawkins should be penalized $5,000;

7. That, pursuant to Section 13.1-521 of the Code of Virginia, Defendant Schoolcraft should be penalized $5,000;

8. That, pursuant to Section 13.1-521 of the Code of Virginia, Defendant Baxter should be penalized $5,000 for each offense, for a total of $10,000;

9. That, pursuant to Section 13.1-519 of the Code of Virginia, Defendants Robert Hawkins, James O. Baxter, Jr., and Charles Schoolcraft should be permanently enjoined from committing such violations of law in the future; and

10. That all other charges should be dismissed for lack of evidence.

Accordingly, ***I RECOMMEND*** that the Commission enter an order that:

1. ***ADOPTS*** the findings contained in this Report; and

2. ***DISMISSES*** this case from the Commission's docket of active causes.

COMMENTS

The parties are advised that any comments (Section 12.1-31 of the Code of Virginia and Commission Rule 5:16(e)) to this Report must be filed with the Clerk of the Commission in writing, in an original and fifteen (15) copies, within twenty-one (21) days from the date hereof. The mailing address to which any such filing must be sent is Document Control Center, P.O. Box 2118, Richmond, Virginia 23218. Any party filing such comments shall attach a certificate to the foot of such document certifying that copies have been mailed or delivered to all counsel of record and any such party not represented by counsel.

Respectfully submitted,

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Howard P. Anderson, Jr.
Hearing Examiner